

Testimony of

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Thank you for having me here today. I would like to emphasize at the outset that I am speaking today in my personal capacity. I was the first General Counsel of the Public Company Accounting Oversight Board, but I do not speak for the Board or its staff. My law firm, Gibson, Dunn & Crutcher LLP, represents a number of accounting firms, but my testimony today is my own.

While there are hundreds of public accounting firms in the United States, a relatively small group of large U.S. firms have historically provided audit and attest services for most public companies and, particularly, for the largest companies. For example, the four largest U.S. accounting firms audit companies having roughly 99 percent of public company annual sales in the United States.¹ Commencing in the 1980s and continuing through the 1990s, a number of the large U.S. firms consolidated so that by the turn of the twenty-first century only five very large firms remained. Consolidation was driven by the perceived need of accounting firms to develop the scale to handle audits and attest work for the largest national and multinational public companies that were themselves increasingly becoming global enterprises, to develop

¹ See U.S. General Accounting Office, Public Accounting Firms, Mandated Study on Consolidation and Competition, July 30, 2003, at 2.

specialized technical expertise and to build large international networks and offices in every major business center in the world.

In 2002, when the Department of Justice indicted Arthur Andersen and Co. for obstruction of justice, we learned just how fragile a major professional services firm can be to the mere pendency of a criminal charge. Within a matter of weeks after the indictment against Andersen had been filed, most of the firm's major clients had moved to other auditing firms, the firm had begun to experience a lethal number of defections of its most skilled professionals, and the Andersen international network fell apart as Andersen firms in other countries sought alliances with other networks. The collapse of Andersen left only a limited number of major U.S. firms to audit the largest public companies.

If consolidation led to today's level of concentration in the accounting profession, what sustains it? For one thing, as the GAO pointed out in 2003, there appear today to be significant barriers to entry for some firms to reach to size and scale of the "Big 4" auditing firms and to be able to serve the market of the largest public national and multinational companies. Smaller firms may lack or may be perceived by the marketplace to lack the staff, breadth and depth of technical expertise and global reach that the largest multinational companies believe they require in their auditors. Additionally, some smaller firms consciously choose not to try to reach the size and scope of the Big 4 firms, feeling that auditing the largest companies not only may greatly increase infrastructure costs but disproportionately increases litigation risk and defense and insurance costs. Finally, sometimes lenders, investors, investment bankers or credit rating agencies will insist that a company seeking to access the capital markets have its financial statements audited by one of the largest accounting firms, adding a bias that has the practical effect of being a barrier to entry.

Despite these barriers, the second four accounting firms have in fact grown proportionately more rapidly than the largest firms since the passage of the Sarbanes-Oxley Act as the Big 4 firms shed a number of audit clients after 2002. In part, this occurred because of Sarbanes-Oxley's limitations on the non-audit services that accounting firms could perform for audit clients and in part this occurred as audit firms became more selective in the clients they would serve. These, among other factors, have driven growth in the second four firms. In addition, the second four firms have also expanded internationally in some cases as witnessed by the recent consolidation of Grant Thornton and RSM in the United Kingdom. Nonetheless, the gap between the smallest of the Big 4 firms, KPMG, and the next accounting firm, Grant Thornton, in terms of revenues and personnel, remains significant.

Certain other factors also increase the practical consequences of concentration in the accounting profession. For example, in some cases, only particular accounting firms may have, or be perceived to have, unique expertise and global reach in a particular area such as oil and gas, financial services, telecommunications, or other specialized areas, further limiting competition for companies seeking auditors with expertise in those industries. In other cases, a potential client may feel that one or more of the large accounting firms is effectively disqualified as a potential auditor because that firm is the auditor for one or more of the company's major competitors. For example, Coca-Cola and Pepsico are not likely to have the same audit firm. Thus, in some cases a company seeking a large accounting firm may not perceive that it even has four choices.

Despite the existing concentration in the accounting profession, my experience, both at the PCAOB and in private law practice, has been that vigorous competition exists among large accounting firms both in terms of service offerings and in terms of price. That was the GAO's

conclusion in 2003, and my observation is that it has not changed significantly since then. An additional observation has been that smaller accounting firms, particularly the second four firms, are also vigorous competitors and possess substantial skills and breadth of experience. This leads me to conclude that if some of the structural problems of the profession that I will discuss in a moment could be addressed, the problem of concentration might be ameliorated.

Further concentration of the accounting profession would pose a serious danger, however. For example, if there is further concentration of the large U.S. firms, independence issues could be exceptionally difficult to manage. It appears that greater competition thus would be desirable if it could be achieved. Where the existing degree of concentration in the accounting profession seems to create particular dangers is where concentration intersects with the inherent fragility of any professional services firm. Professional services firms, however large and successful they are, are comprised of skilled human beings who have other job options at any time. Professional firms are not made up of large pools of fixed capital; the capital of a professional firm, as the cliché says, gets on the elevator and goes home every evening. Thus, a crippling judgment from litigation or, as we observed in the case of Arthur Andersen, an indictment of the firm can cause the firm's human capital to erode quickly and, once the erosion starts, it is likely to be irreversible and, ultimately, fatal to the firm. In addition to the firm, this sequence of events can have devastating effects on the career paths of the talented individuals who work at these firms, who along the way will likely have foregone any number of different opportunities to remain in the profession. The demise of Arthur Andersen caused hardship for many talented professionals.

The risk of large judgments in civil litigation also poses unique risks to all accounting firms particularly because the standard of liability can, in some cases, unfairly make the auditor

the effective guarantor of the balance sheets of the client, or at least the last deep pocket. In many instances, accounting firms have paid large amounts in settlement simply because the financial risk of taking a case to judgment is too great. In this regard it is worth noting that the average settlement amount in securities class action cases that involved accounting issues rose from \$33.8 million in 2004 to \$94 million in 2005.² To be sure, not all of these sums were paid by accounting firms, but there have been a number of cases where large accounting firms have paid amounts in excess of \$100 million to settle securities class action lawsuits. In addition, when punitive damages are added, a judgment can be a multiple of the client's proved loss. In these situations, the size of the trial court's judgment may cripple an audit firm's ability to obtain an appeal bond and that is not fair or appropriate. Thus, while the largest accounting firms may be well capitalized, even they cannot survive excessive civil judgments. In addition, today large accounting firms find themselves unable to obtain insurance to protect themselves against such catastrophic judgments. While I am not an expert in insurance, as I am sure you will hear from experts in this field, insurance for these types of civil judgments is simply not available – the risks are too great. It seems clear that competition could be enhanced if a way could be found to create affordable insurance for catastrophic civil judgments since fear of such judgments seems to be one factor that limits the appetite of smaller accounting firms for seeking to join the ranks of the largest firms.

What would be the consequence of the dissolution or collapse of another of the largest accounting firms? While no one can say for certain, and the world survived the decline of the number of large accounting firms from five to four, no thoughtful person could welcome the loss

² See PriceWaterhouse Coopers, 2005 Securities Litigation Study, at 17 (2006).

of another large accounting firm. First, because the largest public companies often retain each of the Big 4 firms and some of the second 4 for different non-audit services, the SEC and PCAOB would likely have to modify or suspend, at least temporarily, the independence rules if one of the largest firms were to go out of business, simply to allow large companies audited by the failed firm to find another auditor that did not have independence problems with respect to the company. In addition, potential conflicts of interest and severely restricted choices among qualified auditors would likely be even more of a problem if there were only three large auditing firms. Of course, perhaps most significantly, investor confidence in the reliability of independent audits of financial reports would likely fall significantly with the failure of another auditing firm, causing the capital markets to react negatively.

If, as I believe, the inherent fragility of all large accounting firms coupled with the inability to obtain insurance is a serious problem made more acute by the degree of concentration in the profession, what can be done about it? Several things come to mind where public policy could be helpful without radically changing the structure of our legal liability system. One possible suggestion would be for federal authorities to issue standards as to how auditors should exercise and document their professional judgment— such judgment being an inevitable part of the auditor's work—and provide some protective coverage for audits that meet those standards so that the auditor's judgments can withstand second guessing by regulators and litigants. Another would be to assure that all judgments at the trial level would be subject to affordable appeal bonds so that access to the appellate process would be assured and judgments, particularly punitive damage judgments, could be reviewed. Another suggestion, which I touched on previously, would be to reform the law or to create other mechanisms to permit accounting firms to acquire or afford insurance against catastrophic claims. Also, in criminal matters, the

Department of Justice's apparent willingness to consider using deferred prosecution agreements in appropriate circumstances is a welcome development, reducing the risk posed by a criminal indictment that an entire firm will be brought down by the acts of a few people.